



M E M O R A N D U M

To: Michigan Association of County Drain Commissioners - Legislative Committee

From: Roger Swets & Terry Donnelly

Date: March 24, 2014

Re: Drain Code Revisions to Allow Term Bonds

THE PROBLEM

In short, Michigan drainage districts are facing potentially higher borrowing costs than necessary because the Drain Code requires that drain bonds be issued as serial bonds and does not allow the use of term bonds.

In general, municipal bonds can be issued in two formats, as serial bonds or as term bonds. Traditionally, municipal bonds have been issued as serial bonds, and the Drain Code, PA 40 of 1956, as amended, contains language that requires that drain bonds be issued as serial bonds, not term bonds.

A bond issue with serial maturities is one where a portion of the bonds matures every year, and the portion maturing is represented by a separate bond certificate. Therefore in a bond issue with a final maturity in 10 years, there would be at least 10 bond certificates with at least one certificate maturing each year.

In recent years, term bonds with mandatory redemptions have come into common use as a method of attracting large institutional bond buyers to buy bonds whose serial maturities are otherwise too small to attract large institutional buyers' interest. A term bond does this by taking principal amounts that would come due over more than one year and grouping them together in one bond certificate, but then requiring mandatory principal payments called mandatory redemptions be made each year. Because the mandatory redemptions are required, the principal payment schedule remains the same, even though a larger principal amount is grouped together in one bond certificate. For instance where a serial bond issue might have five bonds of \$100,000 each maturing in five consecutive years, a term bond could be one \$500,000 bond certificate, with \$100,000 coming due by mandatory redemption each year and the final \$100,000 maturing in the fifth year.

The use of term bonds instead of serial bonds is often form over substance from the perspective of the drainage district, but it provides an important difference to bond buyers because it increases the principal amount of the bond (sometimes referred to as the par amount) that they are buying. When underwriters buy a bond and remarket it to the public the bond issue can be traded in \$5,000 increments. While an individual retail buyer might be interested in purchasing a \$5,000 bond, many large institutional buyers, like mutual funds, insurance

Allowing the option of using term bonds in a bond offering allows the purchaser of the bonds to group two or more annual bond maturities into one bond certificate. This allows larger institutional buyers, who are only interested in buying bonds over a certain size, to group several bonds to meet their minimum size requirement.

The ability to use term bonds with mandatory redemptions would help the municipal advisors and underwriters involved in drain financings to structure drain bond issues so that they are more attractive to large institutional buyers and thereby potentially reducing interest rates and the costs borne by property owners and public corporations.

Ultimately, the cost of the higher interest rates that may be paid by drainage districts to issue term bonds is borne by the property owners and public corporations that pay their assessments over time. Because they cannot issue term bonds is because of the property owners and public corporations of the state of Michigan who pay their drain assessments over time. Thus, the inability of drainage districts to issue term bonds potentially increases the cost to property owners and public corporations that pay their assessments over time.

In looking at a larger bond issue, a municipal advisor has told us that the availability of term bonds would increase the size of the bidding pool from 2 to 3 bidders to 6 to 7 bidders, saving as much as 10 basis points in the yield. He said that underwriting spreads would also be higher without term bonds because additional sales credit would be needed to provide incentive to the brokers to sell the smaller pieces in the serial bond structure.

Quantifying the exact impact of this on interest rates is difficult, since the bond market values from day to day and each bond issuer is different. However, in speaking with the underwriting desk of an investment banking firm, we were told that the inability to use term bonds is a particular problem for bond issues of \$5,000,000 or less that have final maturities over 10 years. This underwriting desk believes that having par amounts of at least \$200,000 is critical and that bonds with annual maturities under this amount suffer significantly when they are priced if they cannot be grouped in term bonds. They also stated that to obtain the best results bonds that have a maturity over ten years need to have a par amount of \$300,000 or more. They estimated that on a given day a \$2,000,000 20 year bond issue may have a yield that is as much as 20 basis points (0.20%) higher if term bonds are not allowed.

Large institutional buyers are too small to attract institutional buyers, the bonds become harder to sell, potentially increasing the interest rates and increasing the risk that the drainage district matures off of the bond issue are too small to attract institutional buyers, the bonds when they are sold. These institutional buyers are one of the main potential buyers of the bonds. If the serial issue goes out beyond 10 to 15 years, banks begin to lose interest in buying the bonds, leaving the large institutional buyers to be interested in them. Furthermore, as the final maturity of a bond increases institutional buyers to be interested in them. Bond issues that are a smaller size may have annual maturities that are too small for companies and other large institutions, are not interested in buying bonds that have smaller par amounts.

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bond issue, and potentially reduces the overall interest rate for the bond issue. In simple terms, if adding the option of term bond maturities makes it easier to sell some of the more difficult bond maturities, it can potentially lower the overall interest rate.

To provide a simple example, a 20 year, \$2,000,000 bond issue might have annual serial maturities of \$200,000 per year. A large institutional buyer may have a policy that it does not buy bonds with a par amount of less than \$500,000. The serial drain bond with a par amount of \$200,000 is too small to meet this threshold and the institutional buyer is not interested in the drainage district's bond issue. On the other hand, if term bonds were to be allowed for the bond issue, an institutional buyer would be able to direct that the issuer group any number of these \$200,000 maturities together so that there is a bond over the buyer's \$500,000 threshold. The buyer might, for instance, direct that the last five maturities be put together in one term bond, so that instead of five \$200,000 bonds maturing in years 16 through 20, there would be one \$1,000,000 bond maturing in year 20, giving the purchaser a bond with a par amount well over its \$500,000 threshold.

Importantly, while the term bond option allows the purchaser to group a number of serial maturities into one bond maturity, it does not alter the principal payment schedule established by the drainage district. The drainage district would require that the term bond have annual mandatory redemption requirements so that principal would still have to be paid according to the schedule determined by the drainage district. In our example, while the bond buyer would have one \$1,000,000 bond maturing in year 20, the terms of the bond would require that the issuer make annual mandatory principal redemption payments of \$200,000 per year, thus preserving the principal payment schedule that the drainage district wants to see.

It also needs to be mentioned that term bonds will not be beneficial in every financing. Since a term bond will have one single interest rate for the years grouped together in the term bond, it loses the benefit of the yield curve which can increase the interest rate for that portion of the bond issue. Proper use of term bonds, however, where they improve the pricing of the overall pricing of a bond issue, offer a valuable tool and can potentially lower interest rates.

PUBLIC POLICY CONSIDERATIONS

Allowing the use of term bonds with mandatory redemption requirements provides a public policy benefit by potentially lowering borrowing costs for Michigan drainage districts, without changing the principal repayment schedule of the bond issue.

Allowing the use of term bonds with mandatory redemptions has the advantage of potentially lowering borrowing costs for Michigan drainage districts and thus ultimately the cost of drain projects to Michigan property owners and public corporations.

There appear to be no public policy objections to the proper use of term bonds with mandatory redemptions, since they maintain the same principal payment schedules as serial bonds. Other statutes governing special assessment financings allow the use of term bonds,

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Perhaps the strongest indication that there is no public policy objection to term bonds
with mandatory redemptions comes from the fact that the Revised Municipal Finance Act, PA 344
of 2001, as amended, the statute which regulates most public finance activity in Michigan,
limits the use of term bonds. Section 503 of the Revised Municipal Finance Act provides
that bonds may mature serially or be subject to mandatory redemptions (which are features of
term bonds).

(1) Municipal securities of a single issue may mature serially or be subject to
mandatory redemptions, or both, with maturities as fixed by the governing body
of the municipality. In any case, the first maturity or mandatory redemption date
shall occur not later than 5 years after the date of issuance, and the total principal
amount maturing or subject to mandatory redemption in any year after 4 years
from the date of issuance shall not be less than 1/5 of the total principal amount
maturing or subject to mandatory redemption in any subsequent year. MCL
141.2503(1).

Section 503(1) evidences a public purpose that bonds are repaid in a prompt fashion. It
limits the amount of time that a municipality can go without making principal payments on its
bonds, requiring that principal payments must start by year five and after that point must meet a
minimum size requirement each year. Despite the fact that section 503(1) is furthering a public
policy of prompt principal payments for bonds, it explicitly recognizes that this goal can be met
with either serial bonds or term bonds with mandatory redemptions. It sanctions the use of term
bonds with mandatory redemptions in all bond issues under the Revised Municipal Finance Act
unless another statute has more restrictive language, which unfortunately the Drain Code
contains.

Section 275 of the Drain Code appears to echo this policy concern. It requires that drain
bonds for Chapter 8 drains mature not later than June first of the year following
the due dates of the respective installations of assessments levied for a drain project which are
collected but not used in a way to pay bonds. When the assessments accumulate in an account
for some time, there can be serious problems since the bonds usually accrue interest at a higher
rate than the account where the assessments are deposited, and over time this could lead to a
deficit in the amount of funds needed to make bond payments. This is a similar concern to that
addressed by Section 503 of the Revised Municipal Finance Act. Since term bonds with
mandatory redemptions would require payments on the same bonds with mandatory
serial bonds, however, this policy concern is equally satisfied by term bonds with mandatory
redemptions, just like it is in the Revised Municipal Finance Act.

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FISCAL IMPLICATIONS

The use of term bonds with mandatory redemptions could lower borrowing costs for drainage districts, which are costs that are passed on to property owners and public corporations in the state.

Proper use of term bonds with mandatory redemptions would pose no negative fiscal implications to the state of Michigan or its political subdivisions. Overall interest cost on drain borrowings would not increase where term bonds assist in lower the yield on a bond issue, since the use of term bonds with mandatory redemptions would maintain the same principal payment schedules required for drain bonds in the current provisions of the Drain Code.

Since allowing this tool would potentially reduce borrowing costs for drainage districts, it would provide interest cost savings to the state or any local government that is assessed for a drain project and pays the assessment over time. Similarly it would provide interest cost savings to Michigan property owners who pay drain assessments over time.

EXPLANATION OF REVISIONS

The Drain Code can be amended to allow for term bonds by adding simple references to mandatory redemptions together with several other minor changes.

As mentioned earlier, section 275 requires the maturity of drain bonds under that section within a short time of when the installments of drain assessments are due. It does not allow for mandatory redemptions. Sections 132, 280, 221, 277 and 278, also have references to the maturity of bonds without mentioning the possibility of mandatory redemptions. We suggest amending these sections by adding references to mandatory redemption and making other minor revisions.

Sections 476, 528 and 569 all specifically require that bonds issued pursuant to Chapters 20 through 22 mature serially. We suggest amending those sections by deleting the word "serially" and adding the reference to mandatory redemptions.

We have attached a document that contains the sections of the Drain Code that we believe need to be revised and made suggested revisions to them. The new language is underlined and deleted language is marked with a strikethrough.

Since the use of term bonds with mandatory redemption furthers the same public policy that the use of serial bonds does in the Drain Code, while at the same time potentially reducing borrowing costs for Michigan property owners and public corporations, we believe that amending the Drain Code to allow for the use of this financing tool would be in the public interest of the state of Michigan and its property owners.

CONCLUSION

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